

Decision 00-12-065 December 21, 2000

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the
Commission's Proposed Policies Governing
Restructuring California's Electric Services
Industry and Reforming Regulation.

Rulemaking 94-04-031
(Filed April 20, 1994)

Order Instituting Investigation on the
Commission's Proposed Policies Governing
Restructuring California's Electric Services
Industry and Reforming Regulation.

Investigation 94-04-032
(Filed April 20, 1994)

**ORDER PROPOSING CLARIFICATIONS AND MODIFICATIONS
OF D.00-08-023 AND D.00-09-075, AND ESTABLISHING PRUDENCY
STANDARDS FOR FORWARD ELECTRICITY CONTRACTS**

Summary

This decision proposes for comment clarifications and modifications to two decisions adopted this past summer authorizing Pacific Gas and Electric Company (PG&E), Southern California Edison Company (Edison), and San Diego Gas & Electric Company (SDG&E) to purchase energy and ancillary services and capacity products in the bilateral forward markets under contracts that expire on or before December 31, 2005. The two decisions also established accounts to track the related costs, which were made subject to refund and, under certain circumstances, reasonableness review.

The proposal issued today is prompted largely by our concern that these three utilities may be underutilizing the price-moderating potential of bilateral

forward purchases because of the risk of after-the-fact review of the prudence of the purchases. We take this opportunity to further articulate review standards for comment by parties in the expectation that more detailed review standards will reduce the perceived risk that may be leading to any underutilization of bilateral forward purchases.

We act today in response to Governor Gray Davis' request that we "expeditiously develop benchmarks to assure the reasonableness of these contracts without unfairly 'second guessing'" the utilities' purchase decisions in later years. Governor Davis asked that we complete this process early in 2001 to provide adequate opportunity for contracts to be negotiated and in place before summer 2001. (See Letter of Governor Gray Davis to Chairman James Hoecker, Federal Energy Regulatory Commission, December 1, 2000.) Therefore, the comment period is brief.

Goals of the Emergency Bilateral Forward Contract Program

In Decision (D.) 00-08-023 and D.00-09-075, we authorized PG&E, Edison, and SDG&E to purchase energy and ancillary services and capacity products in the bilateral forward markets under contracts that expire on or before December 31, 2005. This authority was in addition to that given the utilities to purchase these services and products in the California Power Exchange's (PX) Block Forward Markets (BFMs).¹ The purpose for granting this authority was to provide the utilities with additional procurement options that would accomplish

¹ A full regulatory history of forward power purchasing authority and the utilities' actual use of forward markets may be found in the Commission's November 22, 2000, filing at the Federal Energy Regulatory Commission (FERC) in response to the order issued by the FERC on November 1, 2000 (Docket No. EL00-95-000). See especially Exhibits PUC-11 and PUC-12.

two goals. The critical goal that caused the Commission to take up the utilities' motions requesting this authority on an emergency basis was the need to reduce prices and hedge against price spikes. Secondly, recognizing that some suppliers have not been participating in the PX markets, the purpose of having granted the authority is to increase the supply sources on which the utilities may rely.

Background

The utilities each presented argument on its preferred approach to demonstrating the reasonableness of any contracts. The Commission adopted the utilities' requests with some modifications. Below we summarize the basic elements of the authority granted:

1. The three utilities were granted authority to enter into bilateral forward contracts that expire on or before December 31, 2005, subject to previously adopted limits applicable to forward energy products, including capacity products. The Commission did not require that these bilateral forward contracts specify that the products go to physical delivery in the PX markets. The Commission stated that it should continue to oversee procurement practices, and put the utilities on notice that their bilateral forward contract purchasing decisions must meet the standards adopted.
2. The decisions articulated the circumstances under which reasonableness review of Edison and SDG&E near-term (power delivered through December 31, 2002) bilateral forward contracts would occur. Specifically, if the average price of Edison's or SDG&E's bilateral forward transactions, delivered or requiring delivery over the course of an annual period, exceeds the average price of Edison's or SDG&E's remaining portfolio of transactions, delivered or requiring delivery over the same period, by more than 5%, then the Commission will initiate a reasonableness review. The decisions imply

but do not explicitly state that such transactions that are less than or equal to the 5% of average price ceiling are reasonable. A finding of reasonableness regarding such transactions would come in the context of a future proceeding. Any reasonableness review would take place as part of the utility's Annual Transition Cost Proceeding.

3. D.00-08-023 adopted an approach for developing, prospectively, a range of reasonable prices for PG&E near-term and "interim term" bilateral forward contracts. "Interim term" is not defined explicitly, but it can be inferred to parallel the timeframe applied to Edison's medium-term contracts. Contracts entered into by PG&E with prices within that predefined range would be reasonable. The decision implied but did not explicitly state that contracts with prices outside the predefined range would be subject to reasonableness review. Any reasonableness review would take place as part of the utility's Annual Transition Cost Proceeding.
4. D.00-08-023 provided a preapproval process for Edison medium-term contracts (delivery after December 31, 2002). The preapproval process provides that Edison make a compliance filing that includes the bilateral forward contract and justifying support for the contract. The filing would be accepted under Public Utilities Code Section 583 and held confidential. The Energy Division would then approve the contract within 30 calendar days, or, if the Energy Division believes modification to or rejection of the contract is required, it may place a resolution proposing to do so on the Commission's Business Agenda at the earliest possible date. If such an item is placed before the Commission, the contract will not be considered approved until a vote of the Commission, or Energy Division withdraws the item from consideration.
5. The decisions require the utilities to provide certain reports. All utilities provided reports to identify any markets in which affiliates or subsidiaries

operate and in which the utilities intend to procure electricity or ancillary services. PG&E is required to submit to Energy Division and the Office of Ratepayer Advocates (ORA) monthly reports to a) update the sets of prices used by PG&E to establish the range of reasonable prices; and b) provide detailed information on its bilateral forward contracts. SDG&E is required to submit a monthly report to Energy Division on a confidential basis that discloses all bilateral forward contracts.

Discussion

Fundamental to this discussion is the Commission's responsibility to ensure just and reasonable rates as established in Public Utilities Code Section 451. After all, the purpose of having granted the utilities the authority to enter into bilateral forward contracts is to lower costs to ratepayers. Secondly, recognizing that some suppliers have not been participating in the PX markets, the purpose of having granted the authority is to increase the supply sources on which the utilities may rely. These two goals can be conflicting since one way to increase the supply sources willing to sell to a utility is to agree to pay a supplier more. That is why we place the goal of increasing supply sources secondary to the goal of lowering costs.

The market pressure to pay more is also why reasonableness review of the portfolio of bilateral forward contracts continues to be necessary. California's utilities are among the largest purchasers in the western United States. During this time of crisis, it is nevertheless important to provide the utilities guidance on what we may consider reasonable as they conduct negotiations toward developing their portfolios. This guidance should help the utilities to overcome any reluctance they may have in entering into bilateral forward contracts given uncertainty about whether the Commission will allow recovery of the associated costs. But this effort to reduce the utilities' perception of recovery risk must be

balanced with the Commission's responsibility to ratepayers to ensure that rates are just and reasonable.

To that end, this decision proposes for comment the criteria the utilities should consider in developing their bilateral forward contract portfolios. Once finalized after comment, these same criteria should be used by Energy Division and the ORA in the preapproval of individual contracts that our prior decisions established, and which are clarified in this decision. Finally, these same criteria, once finalized, should be used by the Commission in considering the reasonableness of the utilities' procurement practices as they relate to the emergency bilateral forward contract portfolio that the individual contracts, taken together, create.

Preapproval of Individual Contracts

As established in the D.00-08-023, the Commission provides a process for preapproval of certain individual utility bilateral forward contracts. As we stated in D.00-08-023, we would review these transactions for reasonableness, and we would continue to oversee procurement practices. We propose to modify our approach for the preapproval of near-term and medium-term contracts previously adopted.

First, we expect the utilities to present our staff with sufficient information to judge whether the individual contract at issue is reasonable. The utility should provide some context for how an individual contract meets the Commission's goals for the emergency bilateral forward contract program, and the utility's policy and strategy for meeting those goals.

In explaining the reasonableness of its contracts or solicitation plans, the utility should use uniform evaluation criteria. Bilateral contract pricing should be shown in net present value (NPV) terms, and compared to the utility-developed NPV of forecasted prices for the product or service. The portfolio of

contracts, and the volume they represent should be shown and compared to the utility-developed forecast of expected demand so that the reasonableness of the portfolio in meeting expected demand can be evaluated. The utility should use a) a consistent, reasonable discount rate for NPV calculations; and b) consistent products, for example, 6x16 blocks (or peaking offers) should be compared to 6x16 blocks, not 7x24 blocks (or flat offers), unless a good methodology to correct for differences in these products is applied that allows a fair comparison of different blocks.

We propose to replace the reasonableness “5% of average price” ceiling, applied to Edison and SDG&E near-term contracts, the reasonable “pre-defined range” of prices, applied to PG&E, and the pre-approval process for Edison medium-term contracts, with a specific price benchmark. Given conditions in the market today, we would regard a bilateral forward flat (7 days a week, 24 hours a day) contract with a 5-year term, with an energy price below 5 ¢/kWh to be reasonable. We would not further subject that contract to review. Such a contract with an energy price between 5 ¢/kWh and 6 ¢/kWh would also be reasonable except if that contract was entered into with an entity affiliated with a utility. The Commission will use its discretion in determining whether to subject any 5-year bilateral forward flat contract with an energy price above 6 ¢/kWh to reasonableness review.

We recognize that the utilities may need to procure other products and services on a bilateral forward contract basis, like peaking (6 days a week, 16 hours a day) services, and for terms less than 5 years, and seasonal or monthly terms, and ancillary services and capacity products. A price benchmark comparable to the benchmark for the 5-year bilateral forward flat contract should be developed. We expect the utilities to convert the 5-year bilateral forward flat contract 5 ¢/kWh ceiling for a finding of “per se” reasonableness into a

comparable figure (NPV) for the various products and services it intends to procure on a forward basis. We are particularly interested in receiving comments on this proposal that will help us evaluate and develop formulas for these conversions.

The utilities should all disclose their bilateral forward contracts in monthly reports to Energy Division and ORA. These reports, with the details described above, should remain confidential so as not to undermine any utility's ability to aggressively pursue bilateral forward contracts. The staff should receive the PG&E, Edison, and SDG&E reports under Public Utilities Code Section 583.

The price benchmarks are intended to give the utilities an early assessment, prior to entering into a specific bilateral forward contract, of whether that contract meets the goals of the Commission's emergency bilateral forward contract program, under the final criteria for evaluating the contracts. Any individual contract that has prices that meet or beat the appropriate benchmark would not be subject to reasonableness scrutiny as a stand-alone contract, but would be included in the overall review of the reasonableness of the utility's procurement practices as part of the utility's emergency bilateral forward contract portfolio.

We recognize that an individual bilateral forward contract may not, on its own, meet each of the criteria. The absence of prices that meet or beat the appropriate benchmark would not preclude the utility from completing the transaction if the utility management decided it could demonstrate that the transaction meets the goals of the Commission, in the context of the utility's procurement strategy to meet those goals, and when the individual contract is viewed as a component of a portfolio.

Reasonableness of an Emergency Bilateral Forward Contract Portfolio

As the earlier decisions stated, the Commission must consider the reasonableness of emergency bilateral forward contracts and the procurement practices of the utilities. We now clarify that the reasonableness review that we stated we would conduct in the Annual Transition Cost Proceeding would be a review of the portfolio of contracts. It would not be a contract-by-contract review, assuming that the individual contracts meet or beat the appropriate price benchmark.

The Criteria

The attached criteria, issued for comment, together with this decision, and D.00-08-023 and D.00-09-075, are intended to provide the utilities and Commission staff with the Commission's expectations for what the emergency bilateral forward contracts will provide to ratepayers as a component of the utilities' procurement portfolio. We expect the utilities to balance each of the criteria in structuring their portfolios. We do not expect each emergency bilateral forward contract to meet, equally, each of these criteria. We do, however, expect that the utility's emergency bilateral forward contract portfolio will, taken as a group of contracts, meet the Commission's goals for the emergency bilateral forward contract program and the specific criteria we ultimately adopt. We will evaluate whether the goals of the program have been reasonably met by the utilities' emergency bilateral forward contract portfolios with these criteria, once finalized, in mind.

We approach the adoption of these more detailed criteria for comment with some trepidation. These are very fluid times in the energy marketplace. We prefer to rely on utility management to exercise good judgement in making procurement decisions with flexibility to adjust to changing times. We are

disappointed with the fact that the utilities may be underutilizing the price-moderating potential of bilateral forward purchases because of the risk of after-the-fact review of the prudence of the purchases. It is only after seeing this reluctance that we propose for comment more detailed criteria.

Comments

The price-moderating and cost saving effects of the utilities taking advantage of the emergency bilateral forward contract program accrue to ratepayers. We want the utilities to have an adequate opportunity to negotiate contracts under this program and have them in place before summer 2001. Therefore, the time for comments on these proposed criteria is abbreviated.

PG&E, SDG&E, Edison, and ORA shall, and other parties may, comment on this decision and the attached proposed criteria no later than January 8, 2001. Any party filing comments shall serve those comments as provided in Commission Rule of Practice and Procedure 2.3(a). In addition, any party filing comments shall also serve its comments on Chief Administrative Law Judge Carew (lrc@cpuc.ca.gov) and all appearances by electronic mail. If an appearance on the service list has not provided the Commission with an electronic mail address, that appearance shall be served by overnight express mail.

Finding of Fact

We further articulate “per se” reasonable price benchmarks and review criteria for comment by parties in the expectation that more detailed review standards will reduce the perceived risk that may be leading to any underutilization by PG&E, SDG&E and Edison of the authority to enter into emergency bilateral forward contracts granted in D.00-08-023 and D.00-09-075.

Conclusion of Law

It is in the public interest that the time for comments on the attached proposed criteria be brief.

IT IS ORDERED that Pacific Gas and Electric Company, Southern California Edison Company, San Diego Gas & Electric Company, and the Office of Ratepayer Advocates shall, and other parties may, comment on this decision and the attached Criteria for Utilities to Balance in Creating a Portfolio of Bilateral Forward Contracts no later than January 8, 2001. Any party filing comments shall serve those comments as provided in Commission Rule of Practice and Procedure 2.3(a). In addition, any party filing comments shall also serve its comments on Chief Administrative Law Judge Carew (lrc@cpuc.ca.gov) and all appearances by electronic mail. If an appearance on the service list has not provided the Commission with an electronic mail address, that appearance shall be served by overnight express mail.

This order is effective today.

Dated December 21, 2000, at San Francisco, California.

LORETTA M. LYNCH

President

HENRY M. DUQUE

JOSIAH L. NEEPER

RICHARD A. BILAS

CARL W. WOOD

Commissioners

I will file a partial dissent.

/s/ HENRY M. DUQUE

Commissioner

**Criteria for Utilities to Balance in Creating a Portfolio of
Bilateral Forward Contracts**

From whom should the utilities procure?

1. Diversity of Supplies

The utilities should avoid over dependence on any single supply of product or service to the extent that the resulting diversity would reduce risk to ratepayers.

2. Geographic Diversity

The utilities should vary the source of product and avoid transmission constraints within their systems and avoid dependence on, for example, imports or one transmission path of imports to the extent that the resulting diversity would reduce risk to ratepayers.

3. Generation Assets Behind Bids

The utility's bilateral forward contracts should require physical delivery with generation assets behind the bids. This criterion should encourage the utilities to avoid speculative options – an individual supplier may still default on the contract but physical assets behind a bid make possible performance under any contract that is struck.

4. Credit Worthiness

The credit worthiness of any bidder in a bilateral forward contract solicitation is important in assessing the value of the bid. The utilities should include in their solicitations a credit worthiness standard that is generally accepted in established forward markets.

5. Contracting with Affiliates and Other Utilities

When affiliates are allowed to participate in a competitive solicitation, consistent with the Affiliate Transaction Rules (See Appendix B to D.98-08-035, which incorporates modifications of D.97-12-008, and related decisions in R.97-04-001, I.97-04-012), the level of scrutiny of that solicitation is necessarily increased. The purpose of granting the utilities the authority to enter into bilateral forward contracts on an emergency basis was to provide them with additional procurement options on an expedited basis. Uncertainty regarding the reasonableness standard may have quelled the utilities' eagerness to enter into such contracts. Further slowing utility action with the level of scrutiny of any

competitive solicitation necessary when affiliates participate in that solicitation runs counter to our purpose in expediting the authority to enter into bilateral forward contracts. The utilities are strongly discouraged from entering into bilateral forward contracts with their affiliates.

Similarly, the utilities are put on notice that inter-utility bilateral forward contracts would also require increased scrutiny.

What is the preferred process for procurement?

6. Competitive Solicitation

The utility's bilateral forward contracts should largely, though not necessarily exclusively, result from a competitive bid or simultaneous solicitation of bids from multiple suppliers. This criterion should provide the utility, and ultimately the Commission, with a ready method for comparing bids to demonstrate or, in the case of the Commission, evaluate, the reasonableness of a contract. To maintain the competitive integrity of any solicitations, bid data and the identity of bidders should be secret from all other bidders.

How much should the utilities pay for services procured through this program?

7. Contracts with a Positive NPV Relative to Forecasts Expected

The purpose for granting the utilities' requests for expanded authorization to form bilateral forward contracts was to provide additional procurement options that minimize ratepayer costs, and hedge against price spikes. Therefore, we expect that the utility's bilateral forward contracts will secure a cost savings for ratepayers. We expect that the utility's showing will demonstrate that the difference between the NPV of forecasted prices for the contracted services and the NPV of a contract would be a positive number. We recognize that were this calculation to result in a negative NPV differential, the bilateral forward contract may provide price certainty, but not any expected savings from forecasted prices. Price certainty may become more important between now and the close of 2005. We will not now state that contracts to secure price certainty are unreasonable. We do emphasize, however, that the primary purpose of the bilateral forward contracts program is to secure lower prices.

How much forward energy and capacity should the utilities buy through this program?

8. Speculative Volumes in Excess of Need Discouraged

Since the goal of the bilateral forward contracts program is to reduce ratepayer costs, a bilateral forward contracts portfolio that results in volumes under contract that exceed system requirements is discouraged. If utility retained assets plus bilateral forward contract volumes would exceed the amount required to meet system needs, there is a speculative element in the supply portfolio. We will not now state that contracts to secure supply certainty are unreasonable, but such contracts, signed now when the clear purpose of the bilateral forward contracts program is to secure lower prices, are discouraged.

(End of Attachment A)

Commissioner Henry M. Duque, concurring in part, dissenting in part:

I concur in today's decision for it is time for this Commission to set benchmarks to determine the reasonableness of long-term contracts and to eliminate post-hoc reasonableness reviews.

I dissent, in part, because today's decision begins our discussion in the wrong place. Instead of beginning our discussion with FERC's proposed reasonableness standard of 7.4 cents/kWh, it proposes a 5-6 cent/kWh and invites parties to comment on methods for converting this benchmark to a comparable figure for non-standard offerings. This proposed benchmark is also unreasonably low given current market conditions.

While I understand the desire to seek public comment and review on how to evaluate non-standard product offerings, we can do that concurrent with the adoption of the FERC standard of 7.4 cents/kWh today. I also note that the Commission can always revise the standard in the future to reflect changes in gas prices or NOX credits.

I have supported decisions for all three utilities that would allow for pre-approval of forward contracts. I did so with the understanding that this would happen quickly and smoothly to allow the utilities to manage price volatility with these arrangements. Had I known then what I know now, I would have written a standard into the bilateral decisions when I wrote them. Once again, we postpone adoption of a standard.

Utilities should have tools to combat price volatility and to help bring new generation to California. By stalling the utilities' need for guidelines on what we consider reasonable, we are sure to limit their ability to purchase power and avoid the unreasonable prices now charged for power.

The failure to adopt a standard of review for bilateral contracts is profoundly disappointing.

For these reasons, I must note my dissatisfaction with today's decision and respectfully agree in part, dissent in part.

/s/ HENRY M. DUQUE

Henry M. Duque
Commissioner

December 21, 2000

San Francisco, California